V A C O R P

The Honorable Michael E. Fryzel
Chairman, National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

The Honorable Rodney E. Hood
Vice Chairman, National Credit Union Administration

The Honorable Gigi Hyland
Board Member, National Credit Union Administration

Re: Comments on Advanced Notice of Proposed Rulemaking for Part 704

Chairman Fryzel, Vice Chairman Hood, and Board Member Hyland:

VACORP Federal Credit Union (VACORP) appreciates the opportunity to comment on the ANPR for Corporate Credit Unions. VACORP is a corporate credit union headquartered in Virginia serving over 200 member credit unions.

VACORP was established over three decades ago to serve the liquidity and investment needs of credit unions throughout the Commonwealth of Virginia. Payment and settlement services were later added to further meet the needs of members. VACORP has offered these services and we believe we have successfully managed the associated risks since our inception.

Payment Systems

Corporate credit unions are the primary financial institution for the majority of natural person credit unions (NPCUs), offering full lines of account services, settlement services, payment and correspondent services, and investment and liquidity products. The elimination of any of these components would reduce the corporate's value as a cash management provider and effectively lead to greater operational costs, eliminate options for member credit unions to conduct business in a cooperative system and ultimately result in higher costs and fees for the country's over 90 million credit union members.

Corporates should be allowed to maintain the existing business line structure. The recent crisis has underscored several best practices that should be employed, including securing multiple borrowing sources and establishing adequate cash reserves to cover unexpected short-term liquidity swings. Ensuring that funds are available to cover settlement in both normal and stressed scenarios can be achieved through existing corporate liquidity management processes and examiner review rather than stipulated in regulation.

Sound regulation and policy does not eliminate risk, but rather establishes rules that measure and mitigate risks while providing a framework for long-term success. A separation of payment systems from funds management services is not practical or desirable. The business lines a corporate delivers should be determined by members after the applicable risks have been identified and appropriately mitigated.

Product and service offerings should be decided by corporate credit union membership, not the NCUA. The role of the regulator is to provide oversight and enforcement of the regulations, not make management decisions on behalf of the institutions it regulates. Corporate credit unions must be able to offer a full range of products and services, which mirror their for-profit counterparts. Anything less would result in a deterioration of the current credit union system, forcing natural person credit unions to utilize profit driven competitors. The cost incurred by such measures would ultimately result in millions of dollars in expense that would be passed on to the private citizen.

Liquidity and Liquidity Management

Corporates have historically managed liquidity risks very well and have provided liquidity solutions for members through many difficult economic cycles. The current unprecedented economic downturn has created a credit and liquidity crisis few, if any, imagined possible and has tested even the best liquidity plans. Providing liquidity is and should remain a core function of corporate credit unions.

To effectively manage liquidity, corporates currently have measurement and reporting processes in place. To the extent these processes are inadequate to properly assess their cash flows and liquidity risks, regulators can require improvement under best practices and other guidance to improve cash flow and liquidity risk assessment if deemed necessary. Corporates may want to consider minimums on readily available liquid assets and cash, cash flow modeling across prepayment ranges, limits on illiquid asset classes and requirements for diversified funding sources.

Access to the Central Liquidity Facility (CLF) needs to be increased for corporate credit unions. While recent programs such as the SIP and HARP have proven effective, the CLF remains an under-utilized tool for the NCUA during the current financial crisis. The NCUA should take all necessary actions to ensure that the CLF can take full advantage of its statutory authorities to provide liquidity funding to the corporate credit union network.

Field of Membership (FOM) Issues

The current national field of membership policy has fostered healthy competition between corporates, which has resulted in better rates and expanded service offerings for member credit unions. On the other hand, this may have resulted in increased risk-taking as cited in the ANPR contributing to margin compression, lower return on assets and slower capital accumulation.

A return to geographic fields of membership would not necessarily improve corporates' financial prospects or reduce risk. For example, the Federal Home Loan Bank model did not protect those banks from market consequences that are quite similar to those that corporates currently face. An alternative to limiting the corporate credit union FOM would be to require that any NPCU capitalize the corporate credit unions they choose to utilize for investment and/or other services.

Each credit union should be allowed to select a corporate regardless of location and paid-in-capital (GAAP qualifying Tier 1 capital) should be required for a credit union to obtain services. Under this approach, standardized capital requirements would be desired so that corporates do not have an inappropriate disincentive to require sufficient contributed capital. Corporates should be allowed, however, to vary rates of return on their paid-in-capital. This will help build capital and then reward owners for financial performance of the corporate once capital targets are met.

Expanded Investment Authority

Expanded investment authorities for corporates are appropriate to continue generating value for the credit union system. In fact, credit unions may be better served by an expansion and broadening of investment options to limit concentration risk at all levels of the credit union system. For example, credit unions are exposed to direct risks by their holdings of mortgages, auto loans, and credit card receivables. As a result of the current restrictions on corporate investments, corporates are indirectly exposed to essentially the same investment risks through their holdings of securities backed by mortgage, auto loan and credit card receivables. Therefore, rather than curtailing expanded investment authorities, the NCUA should consider revising and extending the scope of its corporate credit union regulation for more effective and efficient risk mitigation across the system.

Risks should be aligned with higher capital levels and other parameters to ensure controls are appropriate. Given the dynamics of market events, a review of parameters governing expanded investment authorities is appropriate. This review should encompass not only corporate systems, expertise, capital levels, and process controls to effectively and safely exercise these authorities, but this review must also evaluate whether NCUA has the appropriate expertise and control processes to monitor, measure, evaluate, and control these activities.

Structure: Two-Tiered System

The need for a wholesale corporate, U.S. Central, continues although that role could change to more strategically serve corporate and natural person credit union interests in the future. A concern with the current structure is that U.S. Central assumes a disproportionately large share of the credit risk under the existing structure, but it has the least amount of capital. Aligning sufficient capital where the risk exposure exists is necessary.

An alternative would be to move toward a structure that keeps certain resources and expertise centralized, but investment purchases occur on the individual corporate's balance sheet instead of U.S. Central's. To gain efficiencies, improve margins, and accelerate accumulation of capital, U.S. Central's role over a period of years could transition away from on-balance sheet term investment management to focus more on off balance sheet activities and as aggregator payment-related functions. This would realign risk and capital back to individual corporates. Transitioning U.S. Central's role to off balance sheet asset management and back office functions such as settlement, risk assessment, and external funding could provide for greater stability and more efficient utilization of capital. Identifying the most effective way to perform these central functions for the Corporate Network is critical for continued innovation and effective risk management.

Corporate Capital

The current market crisis will undoubtedly redefine capital adequacy for corporate credit unions, as it will for all sectors of the financial services industry. Higher capital levels would provide corporates greater ability to either sell securities at a loss when liquidity is needed, or to hold securities that cannot be sold for a fair value and therefore accommodate Other Than Temporary

Impairments (OTTI). Higher capital levels would also enable corporates to retain higher credit ratings which will help ensure the preservation of both member balances and external sources of liquidity.

Natural person credit unions should be required to maintain paid-in-capital with a corporate in order to obtain services. Risk-based capital standards should be implemented in a manner consistent with other federally regulated financial institutions. Caution is required, however, because organizations under Basel standards have many more investment authorities than corporate credit unions. Holding corporates to the same capital levels, without permitting them to have the same level of authorities, could lead to underperformance and disintermediation.

A corporate's retained and undivided earnings, together with its paid-in-capital (PIC) should constitute core (Tier 1) capital. Capital divided by 12-month DANA is the appropriate calculation as stipulated in the current regulation. Using 12-month DANA as the denominator appropriately accommodates fluctuations in assets due to cash flow seasonality of credit unions.

Permissible Investments

Corporate investment authorities should not be limited to those allowed by NPCUs. This would effectively eliminate any interest margin gained by NPCUs resulting in nullification of the corporate role in investment activities. A more pragmatic approach would be to require capital within the corporate system be aligned commensurate to the associated investment risk. Implementing risk-based capital standards will match appropriate investment risk levels to corporates' capital levels and therefore act as a self-regulating force in the process.

Thorough knowledge and expertise must be demonstrated by corporate staff when any type of investment is considered. NCUA should in turn provide expert guidance on investment activities including, but not limited to, specific category risk and appropriate capital levels in regard to such risk.

Credit Risk Management

While published ratings by nationally-recognized statistical rating organizations are a predominant metric for evaluating credit risk associated with investment securities, such ratings are not the only metric that corporates use. Additional inputs include rating agency comments, analyses from other providers (brokers, analysts, and industry sources), internal modeling, historical performance of asset types, and forward looking reviews by industry experts. While generally reliable by historic standards, these metrics have proven to be inadequate throughout the current credit crisis, providing a false sense of confidence as ratings volatility and downward migrations have reached historic levels.

Congress, financial industry regulators, and the financial services industry as a whole must require significant improvement and accountability in the rating agencies' performance. Further, the rating agencies must maintain their independence and minimize conflicts of interest between agencies and issuers.

Ratings from multiple agencies should also be required to enhance credit risk management. Using multiple ratings would prove beneficial as no individual model is perfectly predictive of the future. However, obtaining multiple ratings can also provide a false sense of security as current credit market dislocations were not accurately assessed by any of the rating agencies. To be more effective, rating agencies need to revise their modeling, internal governance, and accountability to both investors and regulatory bodies.

Diversification on a portfolio-wide view needs to be the hallmark of new guidance for corporates going forward. Care should be applied to avoid unintended consequences of increasing risk by tapping more risky sectors or accepting an inadequate risk/return ratio by over-diversification. Adequate risk diversification is the first step in a well managed portfolio. Regulation and examiner guidance should maintain flexibility to adjust diversification limits to meet economic and financial market conditions.

The credit quality of nearly every investment sector has been negatively impacted by the market and economic events that began to unfold in 2007. This makes the setting of concentration or sector parameters problematic. Higher overall capital requirements for corporates as suggested previously will mitigate some of the concentration or sector risks. These risks should be monitored on an individual corporate basis during the examination process.

Credit spread widening should be included as one of the risk parameters in the review of credit risk and this should be included in the reviews of interest rate and liquidity risk. Many Corporates did monitor their aggregate risk of credit spread widening to previous historical credit spreads. However, today those credit stresses are 10 to 15 times wider than previous events over the past 70 years. A capital charge for the current event moving forward will likely raise lending rates and market premiums and may reduce available credit in the marketplace. Therefore, careful consideration of impact must be reviewed prior to establishing the guidelines.

Asset Liability Management

NCUA should reinstate the requirement for modeling and stress testing of net interest income and for credit spread increases in order to identify trends or potential concerns. It should be noted that while increased testing and modeling would be beneficial, this would not have prevented the global meltdown since nearly all securities became illiquid and spreads moved wider simultaneously. Understanding the required capital charge for these events would have necessitated more capital retention in order to meet the credit spread widening event.

NCUA should also consider requiring corporates to obtain external validation of interest rate risk, credit risk, and liquidity risk to ensure that corporates' views of these risk categories are appropriate and consistent with current risk methodologies, new developments, and industry best practices.

Corporate Governance

Compensation and term limits of corporate directors should be determined by credit union owners. The issue of compensating directors is linked to attracting "outside" or "independent" directors. However, compensating corporate directors doesn't solve any current problems and there are many arguments for and against director compensation. Corporate boards or their member credit unions should determine whether to compensate directors and what the compensation structure should be.

There are also many arguments for and against term limits and no single position should be imposed upon corporates. Term limits may be gaining popularity in the credit union system and becoming more the norm than the exception. However, this decision should reside with corporate boards and their member credit unions, not the NCUA. Further, it is inconsistent with cooperative's central tenet of democratic control to deny members the right to decide how they will be represented.

Allowing outside directors is also an issue that should be determined by the owner credit unions. If credit unions own all or the majority of a corporate's residual value, then those credit unions are entitled as a matter of equity to a majority of the voting control. Therefore, NCUA should leave the decision and number of outside directors up to each corporate and their member/owners, but the agency should prohibit outside directors from outnumbering directors from credit unions.

In addition, it should be noted that the current board structures at banks, broker dealers, and other financial industry participants, which have been modified to comply with the Sarbanes-Oxley Act and emerging standards governing accountability and transparency, did not prevent disruptions or insulate these institutions from the market crisis. Therefore, the addition of outside directors cannot be demonstrated to improve the safety and soundness of a financial institution. Accordingly, the NCUA should not require board members to be independent of their credit union or corporate board. The decision to have outside directors should be left to individual corporates, their boards, and their member/owners.

Natural person credit union representation on U.S. Central's board should be considered as this would provide an important perspective. While the business model and lines of business of corporates are different from the consumer oriented loan model that natural person credit unions manage, having experienced and knowledgeable natural person credit union CEOs greatly benefits individual corporates and this could enhance the effectiveness of U.S. Central's role across the industry as well.

We appreciate the opportunity to comment on the ANPR for Corporate Credit Unions and we look forward to further dialogue and collaboration with the NCUA Board and the credit union industry to ensure a viable and strong Corporate Network that serves the needs of its owner/members.

Sincerely,

D Chapman

Don Chapman
Board Chairman

Jim Hansen
President/CEO